

(c) *Effective date.* This section applies to discharges of qualified real property business indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998]

§ 1.108-7 Reduction of attributes.

(a) *In general.* (1) If a taxpayer excludes discharge of indebtedness income (COD income) from gross income under section 108(a)(1)(A), (B), or (C), then the amount excluded shall be applied to reduce the following tax attributes of the taxpayer in the following order:

- (i) Net operating losses.
- (ii) General business credits.
- (iii) Minimum tax credits.
- (iv) Capital loss carryovers.
- (v) Basis of property.
- (vi) Passive activity loss and credit carryovers.

(vii) Foreign tax credit carryovers.

(2) The taxpayer may elect under section 108(b)(5), however, to apply any portion of the excluded COD income to reduce first the basis of depreciable property. To the extent the excluded COD income is not so applied, the taxpayer must then reduce any remaining tax attributes in the order specified in section 108(b)(2). If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income. For rules relating to basis reductions required by sections 108(b)(2)(E) and 108(b)(5), see sections 1017 and 1.1017-1. For rules relating to the time and manner for making an election under section 108(b)(5), see § 1.108-4.

(b) *Carryovers and carrybacks.* The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.

(c) *Transactions to which section 381 applies.* If a taxpayer realizes COD income that is excluded from gross income under section 108(a) either during

or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the distribution or transfer of assets, including basis of property, will be available for reduction under section 108(b)(2). However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets shall not be available for reduction under section 108(b)(2).

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) *Facts.* In Year 4, X, a corporation in a title 11 case, is entitled under section 108(a)(1)(A) to exclude from gross income \$100,000 of COD income. For Year 4, X has gross income in the amount of \$50,000. In each of Years 1 and 2, X had no taxable income or loss. In Year 3, X had a net operating loss of \$100,000, the use of which when carried over to Year 4 is not subject to any restrictions other than those of section 172.

(ii) *Analysis.* Pursuant to paragraph (b) of this section, X takes into account the net operating loss carryover from Year 3 in computing its taxable income for Year 4 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss carryover that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that in Year 4 X sustains a net operating loss in the amount of \$100,000. In addition, in each of Years 2 and 3, X reported taxable income in the amount of \$25,000.

(ii) *Analysis.* Pursuant to paragraph (b) of this section and section 172, the net operating loss sustained in Year 4 is carried back to Years 2 and 3 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

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Example 3. (i) *Facts.* In Year 2, X, a corporation in a title 11 case, has outstanding debts of \$200,000 and a depreciable asset that has an adjusted basis of \$75,000 and a fair market value of \$100,000. X has no other assets or liabilities. X has a net operating loss of \$80,000 that is carried over to Year 2 but has no general business credit, minimum tax credit, or capital loss carryovers. Under a plan of reorganization, X transfers its asset to Corporation Y in exchange for Y stock with a value of \$100,000. X distributes the Y stock to its creditors in exchange for release of their claims against X. X's shareholders receive nothing in the transaction. The transaction qualifies as a reorganization under section 368(a)(1)(G) that satisfies the requirements of section 354(b)(1)(A) and (B). For Year 2, X has gross income of \$10,000 (without regard to any income from the discharge of indebtedness) and is allowed a depreciation deduction of \$10,000 in respect of the asset. In addition, it generates no general business credits.

(ii) *Analysis.* On the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. (Under section 108(e)(8), X is treated as satisfying \$100,000 of the debt owed the creditors for \$100,000, the fair market value of the Y stock transferred to those creditors.) In Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). Pursuant to paragraph (a) of this section, X's net operating loss carryover in the amount of \$80,000 is reduced by \$80,000 of the COD income excluded under section 108(a)(1). In addition, X's basis in the asset is reduced by \$20,000, the extent to which the COD income excluded under section 108(a)(1) did not reduce the net operating loss. Accordingly, as a result of the reorganization, there is no net operating loss to which Y succeeds under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$45,000.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that X elects under section 108(b)(5) to reduce first the basis of its depreciable asset.

(ii) *Analysis.* As in *Example 3*, on the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. In addition, in Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is

reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). As a result of the election under section 108(b)(5), X's basis in the asset is reduced by \$65,000 to \$0. In addition, X's net operating loss is reduced by \$35,000, the extent to which the amount excluded from income under section 108(a)(1)(A) does not reduce X's asset basis. Accordingly, as a result of the reorganization, Y succeeds to X's net operating loss in the amount of \$45,000 under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$0.

(e) *Effective date.* This section applies to discharges of indebtedness occurring on or after May 10, 2004.

[T.D. 9080, 68 FR 42592, July 18, 2003; 68 FR 56556, Oct. 1, 2003. Redesignated and amended by T.D. 9127, 69 FR 26039, May 11, 2004]

§ 1.108(c)-1T [Reserved]

§ 1.109-1 Exclusion from gross income of lessor of real property of value of improvements erected by lessee.

(a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the